The global economy gained momentum in the second half of 2016 supported by a rebound of growth rates in the U.S economy. U.S. monetary policy tightening and the indication of continued tightening in 2017 put upward pressures on bond yields in other advanced economies as well as in emerging and developing economies (EMDEs), and exerted downward pressures on EMDE currencies, including Russia's. The pressure on currency depreciation partly offset the appreciation impact on the ruble from the increase in the world oil-price in December. Russia's economy remained in recession in the third quarter of 2016, yet a positive surprise came from the robust export growth, indicating possible advancements in the economy's diversification. Inventory destocking reversed to inventories restocking, possibly indicating increased confidence in the domestic market. In November, industrial production continued to strengthen as manufacturing expanded. Private consumption however retrenched as growth in real wages was not enough to stabilize consumption. Inflation continued to slow down in December with the 12-month consumer price index dropping to 5.4 percent in December from 5.8 percent in November. From January-November 2016, the federal primary deficit at 1.6 percent of GDP, worsened compared to last year, as lower expenditures were unable to compensate for the drop in oil revenues. However, the non-oil deficit improved to 8.2 percent of GDP in this period (compared to 8.6 percent of GDP in the same period last year). The financial sector seems to have stabilized, although asset quality continues to be weak, and demand for loans remains low. Consolidation in the banking sector continues - the number of banks in Russia has fallen from 733 in the beginning of 2016 to 623 as of January 17, 2017.

The Global Context

The global economy improved in the second half of 2016. Global growth gained momentum in the third quarter, supported by a rebound in the United States, to 3.5 percent in the q/q seasonally adjusted annual rate, while in the Euro Area, growth was broadly steady at 1.4 percent in the q/q seasonally adjusted annual rate, and in China it stood at 6.7 percent, y/y. New export orders and the global Purchasing Managers' Index (PMI) suggest continued improvements in the fourth quarter. In the financial market, the U.S. Federal Reserve increased the policy rate by 25 basis points and indicated more tightening was likely in 2017, putting upward pressures on bond yields in other advanced economies and EMDEs. Whereas initial large capital outflows from EMDE bonds and equity in the immediate aftermath of the U.S. elections have moderated, EMDE currencies depreciated by around 2.5 percent on average amid higher bond yields, U.S. dollar appreciation, concerns on trade policy change, and higher policy risk premium.

Crude oil prices surged in response to the deal between OPEC and non-OPEC producers. Oil prices gained more than 16 percent in December (amid considerable volatility) as OPEC and non-OPEC producers agreed to limit production in order to reduce the glut in the global oil market. Last December, 11 non-OPEC producers—spearheaded by the Russian Federation—agreed to reduce output by 0.56 mb/d. The agreement followed OPEC's November decision to reduce its oil supplies by 1.2 mb/d (Saudi Arabia agreed to cuts of 0.5 mb/d). Russia pledged a 0.3 mb/d reduction in physical production but it will do so gradually, reaching 0.2 mb/d by the end of March and 0.3 mb/d by the end of June. Mexico offered to cut 0.1 mb/d—although its contribution will be made through “managed natural declines” as its output has been falling for more than a decade. Other countries such as Azerbaijan will also use natural declines to count as a cut. Kazakhstan agreed to a modest reduction through a delayed expansion of two smaller fields and they will rely on natural output decline at others. The glut in the global oil market continues to slowly decline amid steady broad-based demand growth. On the supply side, sharply lower investment in non-OPEC countries has led to lower production, notably from the short-cycle U.S. shale oil sector. Global stocks, however, have remained stubbornly high in the past year, particularly in the U.S., despite a lengthy period of low prices. The World Bank’s oil price forecast for 2017 is maintained at $55/bbl as in the October 2016 Commodity Markets Outlook.
Russia’s Recent Developments

The tightening in global financial conditions partly offset the appreciation pressure on the ruble from the higher oil prices in December. In particular, the ruble appreciated by 3.5 percent, m/m, as oil prices (Brent) increased by 16 percent in December (Figure 2). Higher bond yields, U.S. dollar appreciation, and higher policy risk premium partly offset the pressure for appreciation. By mid-January, when oil prices decreased by 1.9 percent, the ruble appreciated by 1.7 percent, largely on expectations of reduced geopolitical pressures.

According to Rosstat’s estimates, in the third quarter of 2016, net exports provided the most support to GDP growth. Surprisingly positive, exports registered a growth of 6.9 percent in the third quarter of 2016 compared to -5.6 and 0 percent in quarters one and two, respectively. Imports continued contracting, although at a slower pace, and thus also positively contributed to GDP growth. Total contribution of net exports to GDP growth totaled 2.5 p.p. compared to 1 p.p. in the previous quarter. In addition to robust growth in energy exports and exports of services, a surge in export growth could reflect non-oil export volume growth, indicating advancements in the process of economic diversification. Inventories destocking, registered in the first two quarters of 2016, reversed to inventories restocking in the third quarter, partly reflecting increased needs in stocks from robust export growth and possibly also pointing to improved business confidence in the domestic market. Real wages also grew, thus creating demand for some sectors and increasing their need for stocks. Gross fixed capital formation stabilized, contracting just by 0.5 percent, less than 9.9 percent and 4.3 percent in the first and second quarters of 2016, respectively. Consumer demand remained depressed, contributing -1.8 p.p. to GDP growth. Overall, in the third quarter of 2016, domestic demand shrunk by 3.1 percent, y/y.

Rosstat revised GDP growth in 2015 to -3 percent from -3.7 percent in the framework of the third revision of GDP. From the production side, the improvement was driven mainly by public services, whose contribution to GDP growth increased by 0.5 p.p. Rosstat revised upwards the growth in state management, from -0.9 percent to 3.4 percent, increasing its positive contribution to GDP growth by 0.3 p.p. Non-tradables accounted for about 0.3 p.p. of the improvement as Rosstat recorded better performances in construction, retail and wholesale trade, while reviewing downwards growth in the financial sector. The total contribution of tradable sectors to GDP growth did not change, but the contribution of manufacturing was revised upwards by 0.2 p.p. with a balancing downward revision on extraction of mineral resources and agriculture. The GDP revision for 2015 might have positive implications for 2016 outcomes due to the carry-over effect.

Positive dynamics in industrial production rolled over to November. Industrial output increased by 2.7 percent, y/y, in November and by 0.8 percent, y/y, in the January-November 2016 period (Figure 3). Seasonally adjusted output growth in industries stood at 0.5 percent, m/m, compared to 0.6 percent in October. Manufacturing output increased by 2.5 percent, y/y, compared to -0.8 percent in October. Industries which produce investment goods registered robust growth in November: machines and equipment grew by 2.5 percent, y/y, and transportation vehicles by 2.8 percent, y/y. Some positive impulse in investment demand was also reflected in construction dynamics: 1.4 percent growth, y/y, the first positive reading since November 2013. Consumer demand indicators remained mixed in November. While market services increased by 0.1 percent, y/y, and 0.3 percent, m/m,
(sa), retailed trade lost 4.1 percent, y/y, and 0.2 percent, m/m, (sa). Russia’s manufacturing PMI continued to strengthen in December, increasing to 53.7 from 53.6 in November (maximum reading in 5.7 years), pointing to higher demand for the sector’s output and possible continued improvement in manufacturing output dynamics in December.

**Figure 3: Industrial production increased in November**

![Graph showing industrial production, manufacturing, and retail trade data from January 2012 to November 2016.](source: Rosstat, Haver Analytics, World Bank team.)

**Consumer inflation slowed down further in December, albeit modestly.** The 12-month consumer price index dropped to 5.4 percent in December from 5.8 percent in November and almost halved from the beginning of the year. Core inflation slowed to 6 percent from 6.2 percent in November (Figure 4). As in the previous two months, in December, annual inflation decelerated for all the categories (food, non-food, and services), while non-food inflation contributed the most to headline inflation. According to the Central Bank, end year annual consumer inflation of 5-5.5 percent put consumer inflation on the trajectory of reaching 4 percent by the end of 2017. Thus, the Central Bank policy proved to be successful in reaching this intermediate goal. On December 16, the Central Bank left the key rate unchanged at the level of 10 percent. According to the Central Bank, as the trend towards a sustainable decline in consumer price growth takes root, it may consider cutting the key rate in the first half of 2017. Annual consumer inflation for January – December 2016 totaled 7.1 percent compared to 15.6 percent last year, in line with our projection. In our baseline scenario, with the World Bank average oil price of US$55/bbl, we expect that annual average consumer inflation will reach 4.5 percent in 2017.

**Figure 4: Consumer inflation continued to slow in December**

![Graph showing consumer inflation data from January 2012 to November 2016.](source: Rosstat, Haver Analytics, World Bank team.)

**Labor market dynamics have been mixed.** Seasonally adjusted unemployment decreased slightly to 5.4 percent in November from 5.5 percent a month ago (Figure 5). In November, real wages grew by 1.7 percent, y/y, and by 0.9 percent, m/m (sa). Pensions continued to decrease in real terms, contracting by 2.8 percent, y/y. Real disposable income dynamics contracted by 5.6 percent, y/y, compared to a contraction of 6 percent, y/y, in September 2016, but they stagnated compared to the figures in October.

**Figure 5: Seasonally adjusted unemployment continued to decrease in November**

![Graph showing seasonally adjusted unemployment data from January 2014 to November 2016.](source: Rosstat, Haver Analytics, World Bank team.)

**From January-November 2016, the federal primary deficit worsened compared to last year, as lower expenditures were unable to compensate for the drop in oil revenues.** The federal primary deficit stood at 1.6 percent of GDP in the January-November period compared to 0.5 percent of GDP in the same period last year. In the first eleven months of 2016, federal budget revenues fell by 1.5 percent of GDP to 15.3 percent compared to the same period a year ago. This was due
to a decline in oil revenues of 1.7 percent of GDP to 5.8 percent of GDP. Meanwhile, primary expenditures declined by 0.4 percent of GDP to 16.9 percent of GDP in the January-November 2016 period. National defense (-0.4 percent of GDP), national security (-0.2 percent of GDP), national economy (-0.1 percent of GDP), and education (-0.1 percent of GDP) were the categories for which expenditures were lower, as a share of GDP, compared to the same period last year. Even with limited indexation of pensions (by 4 percent, which is below inflation), federal budget expenditures for social policy increased by 0.3 percent of GDP. On the back of lower expenditures, the non-oil deficit improved to 8.2 percent of GDP in the January-November period compared to 8.6 percent of GDP in the same period last year. In the first 11 months of 2016 the federal budget balance dropped to 2.3 percent of GDP from -1.2 percent in the same period of 2015.

The general government primary deficit worsened to 0.8 percent of GDP. From January-November, the general government primary deficit worsened to 0.8 percent of GDP from 0.5 percent of GDP in the same period last year. General government revenues dropped to 32 percent of GDP from 32.6 percent of GDP in the 2015 January-November period. General government primary expenditures decreased by 0.3 percent of GDP to 32.8 percent of GDP. Overall the general government budget balance in January - November 2016 was -1.8 percent of GDP compared to -1.4 percent in the same period last year. While the federal budget decreased its primary expenditures, as a share of GDP, by 0.4 percent, regional consolidated budgets’ primary expenditures increased by 0.2 percent of GDP. In the first eleven months of 2016, regional governments posted a primary surplus of 0.8 percent of GDP.

The Rosneft privatization deal was closed at the beginning of January 2017. The Russian state holding company Rosneftegaz closed a deal with Qatar and the commodities trader Glencore. As a result, Glencore International and a Qatar sovereign wealth fund acquired 19.5 percent shares of Rosneft, Russia’s largest oil company, for 10.2 billion euros. In the middle of December, Rosneftegaz channeled Rub 710 billion (692 billion rubles for the shares and an additional 18 billion rubles) to the federal budget revenues.

The banking system has largely stabilized but has not fully recovered from the economic recession: asset quality continued to be weak and demand for loans remained low. Credit to firms, adjusted for exchange rate movements, decreased by 2.1 percent in November, y/y, compared to a contraction of 1.1 percent in October. Lending to households, adjusted for exchange rate movements, grew by 1.2 percent in November, y/y, from 0.4 percent in October. However, the worsening trend in non-performing loans decelerated and the banking sector’s capitalization remained stable with an aggregate capital adequacy ratio of 12.7 percent (above the regulatory minimum of 8 percent) as of November 1, 2016 (Figure 6). Banks’ financial performance has been improving, with the return on assets at 0.9 percent and return on equity at 7.9 percent as of November 1, 2016. Consolidation in the banking sector continued mainly due to the Central Bank’s efforts to clean up the banking system - the number of banks in Russia has fallen from 733 in the beginning of 2016 to 623 as of January 17, 2017.

Figure 6: Asset quality continues to be weak

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1 The general government budget includes the federal budget, consolidated regional budget and extra-budgetary funds (the Pension Fund, the Social Security Fund, and the Federal Fund for Mandatory Health Insurance).